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No. 93-878

In the Supreme Court of the United States

OCTOBER TERM, 1993

HAROLD M. PROVIZER AND JOAN PROVIZER,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether an underpayment of tax is "attributable to" a "valuation overstatement"—and is therefore subject to the addition to tax imposed by Section 6659(e) of the Internal Revenue Code, 26 U.S.C. 6659(e)—when the relevant transaction involved a significant overvaluation of property and lacked economic substance.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-6a) is unpublished, but the decision is noted at 996 F.2d 1216 (Table). The opinion of the Tax Court (Pet. App. 7a-62a) is reported at 63 T.C.M. (CCH) 2531.

JURISDICTION

The judgment of the court of appeals was entered on July 7, 1993. On September 24, 1993, Justice Stevens extended the time to file a petition for a writ of certiorari to and including December 4, 1993. The petition was filed on December 3, 1993. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. In 1981, Packaging Industries, Inc., manufactured and sold six Sentinel EPE Recyclers to ECI Corporation for $5,886,000. The recyclers were, in turn, sold by ECI to F&G Corporation (Pet. App. 2a, 25a). F&G leased the recyclers to a limited partnership called Clearwater Group. Clearwater contemporaneously licensed the recyclers to FMEC Corporation, which sublicensed them back to the manufacturer, Packaging Industries (*id.* at 2a, 25a-26a). These transactions "were structured in such a way that all of the payments" due among the various entities offset each other (*id.* at 2a, 46a, 52a). Packaging Industries then sublicensed the recyclers to entities for use in recycling plastic scrap (*id.* at 2a, 27a). This series of transactions is hereafter referred to as the "Clearwater Transaction."

In November 1981, petitioner Harold Provizer paid $8,333 for a one-sixth interest in a general partnership (DL & Associates) that owned a partnership share of the Clearwater Group (Pet. App. 2a, 24a). On their 1981 federal income tax return, petitioners claimed three tax benefits from their participation in this transaction:[1] (i) an investment tax credit of $7,195; (ii) a business energy investment tax credit of $7,195; and (iii) an operating loss of $6,668 (*id.* at 2a, 12a-13a).

In April 1986, the Commissioner of Internal Revenue issued a notice of deficiency disallowing the deductions and credits that petitioners claimed with

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[1] Joan Provizer is a party to this suit because she filed a joint return with her husband, Harold, for 1981 (Pet. App. 12a).

respect to the Clearwater Transaction (Pet. App. 8a). The Commissioner determined that petitioners owed additional income taxes for 1981 in the amount of $17,724 and were also subject to additions to tax for a valuation overstatement ($4,317) and for negligence ($866 plus 50% of the interest due on the deficiency) and an increased rate of interest pursuant to 26 U.S.C. 6621(c) (Pet. App. 2a-3a, 8a). Petitioners sought review of these determinations by filing a timely petition in Tax Court (*id.* at 3a).[2]

2. The Tax Court determined that the Clearwater Transaction was a sham that lacked economic substance and business purpose. In reaching that conclusion, the court found that the fair market value of each recycler in 1981 was no more than $50,000 (Pet. App. 39a), rather than the $1,162,666 upon which petitioners computed their share of deductions and tax credits (*id.* at 46a-50a). In determining that the transaction lacked economic substance, the court explained that "[t]he manner in which the transaction was structured, the lack of arm's-length dealings, and the discrepancy between the fair market value and purchase price on which the pass-throughs were based show the true nature of these transactions" (*id.* at 51a). The court noted that, when the actual fair

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[2] Similar deficiencies and additions to tax were asserted against other participants in the Clearwater Transaction. Those taxpayers also filed petitions in the Tax Court. Petitioners' case was selected as the lead case. Many of the other taxpayers have agreed to be bound by the outcome of this litigation with respect to all deductions, credits, and additions to tax, as well as the increased rate of interest resulting from their participation in the Clearwater Transaction (Pet. App. 9a).

market value of the recyclers is taken into account, cash-flow analysis demonstrates that the transaction had no realistic possibility for economic profit (*id.* at 56a). As the court observed, "a grossly inflated purchase price which has [no] relationship to fair market value was conjured up to maximize the available deductions and credits" (*id.* at 51a).

The Tax Court concluded that the Clearwater Transaction was so lacking in economic substance that it must be disregarded for federal income tax purposes: the claimed tax deductions and credits resulting from the transaction were therefore properly denied (Pet. App. 59a). The court also sustained imposition of the addition to tax under Section 6659 for a "valuation overstatement" because assets with a fair market value of $50,000 were valued on petitioners' return at $1,162,666—a valuation that exceeded the correct value by more than 150% (Pet. App. 61a). See 26 U.S.C. 6659(c).

3. The court of appeals affirmed. The court concluded that the Tax Court had correctly determined that the Clearwater Transaction was a sham (Pet. App. 4a). With respect to the addition to tax for valuation overstatement, the court of appeals explained that "when an underpayment of taxes is caused by disallowance of a deduction for lack of economic substance and the lack of economic substance is due to an overvaluation, 'the deficiency is attributable to an overstatement of value and is subject to the penalty under section 6659'" (*id.* at 5a, quoting *Illes* v. *Commissioner*, 982 F.2d 163, 167 (6th Cir. 1992), cert. denied, 113 S. Ct. 1579 (1993)). Because the transaction at issue in this case "was found to be a sham largely because the recyclers were overvalued," the

court of appeals held that the addition to tax was properly imposed (Pet. App. 5a).

ARGUMENT

1. At the time this case arose, Section 6659 of the Internal Revenue Code imposed an addition to tax of up to 30% on any underpayment of tax "attributable to a valuation overstatement." 26 U.S.C. 6659.[3] Under this statute, a "valuation overstatement" occurs when a taxpayer reports on his tax return either a value or an adjusted basis for property that is 150% or more of the correct valuation or adjusted basis. 26 U.S.C. 6659(c). The court of appeals correctly held in this case that an addition to tax under Section 6659 is appropriate when the taxpayer's underpayment of tax is "attributable to" a significant overvaluation of property for a transaction that lacks economic substance. Pet. App. 5a. The court's conclusion tracks the plain language of the statute. See *Illes* v. *Commissioner*, 982 F.2d 163, 167 (6th Cir. 1992) (since the entire artifice of the shelter was based on the overvaluation of assets, the underpayment is attributable to a valuation overstatement), cert. denied, 113 S. Ct. 1579 (1993); *Gilman* v. *Commissioner*, 933 F.2d 143, 151 (2d Cir. 1991) (lack of economic substance was due in part to the overvaluation and thus the underpayment was attributable to the valuation overstatement), cert. denied, 112 S. Ct. 871 (1992); *Massengill* v. *Commissioner*, 876 F.2d 616,

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[3] Section 6659 of the Internal Revenue Code was repealed by the Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7721(c)(2), 103 Stat. 2399. Provisions similar to those formerly contained in Section 6659 are now found in Section 6662(e) of the Code. See 26 U.S.C. 6662(e) (Supp. I 1989).

619-620 (8th Cir. 1989); *Rybak* v. *Commissioner*, 91 T.C. 524, 566-567 (1988).

2. Contrary to petitioners' contention, the decision of the court of appeals does not conflict with the decisions of the Fifth Circuit in *Todd* v. *Commissioner*, 862 F.2d 540 (1988), and *Heasley* v. *Commissioner*, 902 F.2d 380 (1990), or with the decision of the Ninth Circuit in *Gainer* v. *Commissioner*, 893 F.2d 225 (9th Cir. 1990). Those cases did not involve the disallowance of credits or deductions for transactions that lacked economic substance. Instead, in both *Todd* and *Gainer*, the claimed deductions were disallowed because the property at issue had not been "placed in service" during the taxable year.[4] In that circumstance, the taxpayers' valuation of the property had "no impact whatsoever on the amount of tax actually owed." *Todd* v. *Commissioner*, 862 F.2d at

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[4] Petitioners mistakenly contend (Pet. 12) that, because the Tax Court found (Pet. App. 54a) that the recyclers had not been shipped to an end-user by the end of 1981, the Tax Court implicitly disallowed the deductions and tax credits on the "independent basis" that the recyclers had not been placed in service. The court's findings with respect to the shipment of the recyclers was integral to its explanation that the Clearwater Transaction lacked any business purpose (*id.* at 53a-58a). The court made no express findings as to when the property was actually placed in service. This is presumably because petitioners are lessors of the equipment rather than users. Equipment acquired for lease in a taxpayer's leasing venture can be "placed in service" at the time held out for lease notwithstanding the end-user's need to take additional steps to make the equipment operational. *Cooper* v. *Commissioner*, 88 T.C. 84, 113-114 (1987) (property held for leasing to others in a profit-motivated leasing venture is placed in service when it is first held out for lease); *Waddell* v. *Commissioner*, 86 T.C. 848, 897-898 (1986) (same), aff'd, 841 F.2d 264 (9th Cir. 1988).

543. See also *Gainer* v. *Commissioner*, 893 F.2d at 228 ("Even if Gainer had correctly valued the container, the underpayment of tax would be the same because the container was not placed in service.").

In the present case, by contrast, the Tax Court found that the recycling machinery was significantly overvalued on petitioners' return and that the Clearwater scheme was an economic sham (Pet. App. 46a-56a). Since the tax credits were claimed with respect to the machinery's overvalued basis, the petitioners' underpayment of tax is attributable to that valuation overstatement and the addition to tax under Section 6659 was properly imposed (Pet. App. 5a).[5] See also *McCrary* v. *Commissioner*, 92 T.C. 827, 859 (1989) (an addition to tax is proper under Section 6659 when a valuation overstatement is "an integral part of or is inseparable from the ground found for disallowance of an item"). The holding of the court of appeals in this case is thus consistent with *Todd* and *Gainer*, not in conflict with them.

Finally, in *Heasley*, the Commissioner determined tax deficiencies on a number of alternative grounds,

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[5] Petitioners err in relying (Pet. 9) on the "Blue Book" explanation of Section 6659 in the report issued by the Staff of the Joint Committee on Taxation, 97th Cong., 1st Sess., *General Explanation of the Economic Recovery Act of 1981*, at 333 (1981). The explanation states that whether a tax underpayment is attributable to a valuation overstatement will be determined after taking into account any "other" proper adjustments to tax liability. *Ibid.* The Blue Book formula is appropriate when there are several different types of errors by the taxpayer in the same year. It does not apply when a taxpayer's entire scheme was exposed as a sham and the associated credits and deductions claimed by the taxpayer are disallowed.

"including, among others, that petitioners did not have a profit objective, that the EMS units were not qualifying property, *that they were not placed in service*, and that the units were overvalued." *Heasley* v. *Commissioner*, 55 T.C.M. (CCH) 1748, 1754 (1988) (emphasis added). The taxpayers conceded in *Heasley* that they were not entitled to the investment tax credits they had claimed, but they declined to state any specific basis for their concession. They then argued that, since they had conceded the deficiencies, "it is impossible to determine the reason for any understatement" (*ibid.*) and they therefore should not be held liable for an addition to tax under Section 6659. The Fifth Circuit accepted that contention, concluding that, when a deduction or credit is disallowed in its entirety, the underpayment can not be said to be attributable to a "valuation overstatement" but is instead "attributable to claiming an improper deduction or credit." 902 F.2d at 383.

Although the Commissioner does not agree with the seemingly broad language of the *Heasley* decision, *Heasley* did not involve a situation in which the taxpayer's return relied on a substantial overvaluation of property in claiming tax benefits from a transaction that the court found lacked economic substance. Neither in *Heasley* nor any other decision has the Fifth Circuit directly ruled whether application of the Section 6659 addition to tax would be warranted in that context. In all prior cases where those precise facts have been presented, the courts of appeals have consistently reached the conclusion that the Section 6659 addition to tax properly applies. See pages 5-6, *supra*. There is thus no present direct

conflict in the decisions of the courts of appeals. Further review is therefore not warranted.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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